No. 12,080

IN THE

United States Court of Appeals

For the Ninth Circuit

BASALT ROCK CO., INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF.

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OPINIONS BELOW.

The opinion of the Tax Court (R. 148) is reported in 10 T.C. 600. The dissenting opinions of Judge Van Fossan (R. 170) (concurred in by Judges Arundell, Black and Johnson) and of Judge Kern (R. 176) (concurred in by Judges Arundell and Black) are reported in 10 T.C. 612 and 615, respectively.

STATEMENT AS TO JURISDICTION.

Petitioner filed its income and excess profits tax returns for the calendar year 1942 with the Collector of Internal Revenue at San Francisco, California (R. 54). On January 25, 1946, respondent mailed to petitioner a notice of de-

ficiency in excess profits tax for the year 1942 in the amount of $583,003.64 (R. 5, 16, 36). Petitioner filed with the Tax Court a petition for a redetermination and amendments thereto, alleging that there was no deficiency but that, instead, petitioner had overpaid its excess profits tax in the amount of $935,575.38 (R. 50-51). On July 12, 1948, the Tax Court rendered its decision determining a deficiency in excess profits tax and income tax (R. 189). This decision was later vacated (R. 192), and thereafter final decision was rendered on August 30, 1948 (R. 193), determining a deficiency in excess profits tax for the year 1942 in the amount of $355,342.21. The petition for review by this court was filed on September 29, 1948 (R. 194, 204).

This court has jurisdiction under the provisions of sections 1141 and 1142 of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are quoted, as pertinent, in succeeding portions of this brief, and are copied in full in the Appendix.

STATEMENT OF THE CASE.

This case involves petitioner's excess profits tax for the year 1942. One single issue of law is presented. The petition in the Tax Court (R. 4), the two amendments thereto (R. 39, 45), and the opening statements of counsel for each party (R. 82, 87) refer to certain complicated issues that earlier were involved. All of these were resolved by

stipulation. The sole question remaining concerns the construction of section 710(a)(1)(B) of the Internal Revenue Code, the familiar 80 per cent limitation on total income and excess profits taxes. The facts giving rise to this question are all stipulated, the findings of fact of the court below being simply an adoption of these stipulated facts (R. 149).[1]

The pertinent facts may be summarized as follows:

Petitioner is a California corporation engaged in shipbuilding and the manufacture of concrete aggregates, road and fuel oils, and building material (R. 54). During the year 1942, and prior and subsequent thereto, part of its operations consisted of the performance of long-term con-

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[1]The only issue is a clear-cut question of law, the decision of which by the Tax Court, even under the rule of *Dobson v. Commissioner* (1943) 320 U.S. 489, would have been reviewable by appellate courts (*Trust of Bingham v. Comm'r* (1945) 325 U.S. 365; *Lurie v. Commissioner of Internal Revenue* (9 Cir. 1946) 156 F.2d 436). With the abolition of the *Dobson* rule by the Act of June 25, 1948 (c. 646, 62 Stat. ....., enacting among other things the new Judicial Code), there is no question that even issues of fact decided by the Tax Court are reviewable by the circuit courts to the same extent as if such issues had been decided by the district courts in civil actions tried without a jury. Section 36 of the Act of June 25, 1948, amends section 1141(a) of the Internal Revenue Code to provide:

> "The circuit courts of appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code."

Under this statute questions of law decided by the Tax Court are fully open for review by the circuit courts. The statute specifically limits the weight of the Tax Court's decision to that which the circuit court would give to the decision of a district court.

tracts, that is, contracts requiring more than 12 months to perform.[2] In 1942 petitioner performed work on six such contracts, of which two were completed during the year and four were not completed until a later year (R. 55-56).

The method of accounting regularly employed by petitioner with respect to long-term contracts was the completed contract method (R. 55). Under this method gross income from such contracts is included, and all expenditures allocable thereto are deducted, in the taxable year in which the contract is completed. This method clearly reflected petitioner's net income and was consistently followed by it.[3] Its long-term contract income for all corporate purposes was computed on this basis, and its federal income taxes (normal tax and surtax) for the year 1942 and for previous and subsequent years were computed, as they were required to be computed,[4] on the same basis (R. 55).

During the tax year in question (1942) there were in effect both the ordinary corporation income taxes (the normal tax and surtax), at an aggregate rate of 40 per cent, imposed by Chapter 1 of the Internal Revenue Code, and the excess profits tax at a straight rate of 90 per cent, subject to an over-all 80 per cent limitation (discussed below), imposed by Subchapter E of Chapter 2 of the Internal Revenue Code.

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[2]"The term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted" (Treasury Regulations 111, sec. 29.42-4, Appendix, p. x).

[3]R. 55; Regs. 111, sec. 29.42-4, Appendix, p. xi.

[4]Regs. 111, secs. 29.41-1, 29.42-4, Appendix, pp. ix, x.

The Chapter 1 taxes—the ordinary income taxes—were imposed upon the "normal tax net income" and "surtax net income" of the corporation. These in turn were based upon the "net income" of the corporation—its ordinary commercial income—computed under the familiar provisions of Chapter 1 which have been in effect without basic change throughout the entire history of the income tax acts. The excess profits tax, on the other hand, was imposed upon the "adjusted excess profits net income," a special statutory income computed under the highly complex provisions of the Excess Profits Tax Act which was quite different from the corporation's ordinary commercial income. (A further review of these statutes is given below, infra, pp. 16-24.)

By the Revenue Act of 1942[5] Congress amended the Excess Profits Tax Act (Subchapter 2E of the Internal Revenue Code) by adding a provision intended to afford special relief to taxpayers engaged in the performance of long-term contracts. That amendment, section 736(b), provided in part:[6]

> "In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months * * * it may elect, in its return for such taxable year for the purposes of this subchapter, * * * to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting."

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[5]Act of October 21, 1942, sec. 222(d), c. 169, 56 Stat. 798.
[6]Quoted in full, Appendix, p. vi.

Petitioner was eligible to, and did, make the election provided in the foregoing section,[7] and in its excess profits tax return for the taxable year 1942, in arriving at its adjusted excess profits net income, computed its income from long-term contracts on the percentage of completion method of accounting.[8] Under this method, the gross income from long-term contracts is reported upon the basis of the percentage of the contract work performed during the taxable year, and all expenditures entering into the performance of the contract during the taxable year are deductible in such year.[9] In computing its income from long-term contracts on this basis for the purpose of arriving at its "adjusted excess profits net income," income from contracts not completed in 1942, and therefore not reflected in petitioner's ordinary corporate income, was included; at the same time losses suffered on contracts completed in 1942, and therefore reflected in petitioner's ordinary corporate income for that year, were included in the adjusted excess profits net income only to the extent that they arose out of performance during 1942 (R. 56, 57). On this special basis, taking into account all of petitioner's income, including that from long-term contracts, its adjusted excess profits net income for the year 1942 was $1,845,468.76 (R. 61). In 1942, apart from the alternative measure provided by the 80 per cent over-all limitation of

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[7]R. 55; Petitioner's Ex. 1, p. 5. By order of this court (R. 217) this exhibit, petitioner's income tax return for 1942, is not printed but is before this court in the form certified.

[8]Petitioner's Ex. 2. By order of this court (R. 217) this exhibit, petitioner's corporation excess profits tax return for 1942, is not printed but is before this court in the form certified.

[9]Regs. 111, sec. 29.42-4(a), Appendix, p. x.

section 710(a)(1)(B) (quoted below), the rate of tax on the adjusted excess profits net income was 90 per cent. Accordingly, at the 90 per cent rate, petitioner's excess profits tax would have been $1,660,921.88.

However, by the same statute (the Revenue Act of 1942), Congress had also amended the Excess Profits Tax Act by adding (at the same time the rate was increased to 90 per cent) section 710(a)(1)(B), the familiar provision limiting total income and excess profits taxes for each taxable year to 80 per cent of the corporation surtax net income computed under section 15 of Chapter 1 of the Internal Revenue Code. This section provided:

"SEC. 710. IMPOSITION OF TAX.

(a) *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 per centum of the adjusted excess profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) [i.e., the normal tax and surtax] equals *80 per centum of the corporation surtax net income, computed under section 15*[10] or Supplement G, as the case may be, but without regard to the credit

[10]Emphasis throughout the brief is added, unless otherwise indicated.

provided in section 26(e) (relating to income subject to the tax imposed by this subchapter)."[11]

Section 15, to which reference is made in the limitation provision of section 710(a)(1)(B) above and under which the corporation surtax net income to be used for the purposes of the 80 per cent limitation is computed, is in Chapter 1 of the Internal Revenue Code. As we have pointed out, section 15 provides for the computation of the corporation's surtax net income under familiar concepts that, in their basic aspects, have been in the law since the first income tax statute was enacted.[12]

So far as pertinent, section 15[13] provides:

"(a) CORPORATION SURTAX NET INCOME.—For the purposes of this chapter, the term 'corporation surtax net income' means the *net income* minus [certain credits] * * *.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the corporation surtax net income of every corporation * * * a surtax as follows: * * *."

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[11]Supplement G is in Chapter 1. It provides for the manner in which the surtax net income of insurance companies is to be computed.

Section 26(e) was added to Chapter 1 of the Code by the Revenue Act of 1942 at the same time that the rate of tax on the adjusted excess profits net income was increased to 90 per cent, subject to the over-all 80 per cent limitation. It is a credit against the normal tax net income and surtax net income before they are subjected to the Chapter 1 income taxes. The credit in the ordinary case is the amount of the adjusted excess profits net income. By providing for this credit Congress assured that the amount of the adjusted excess profits net income, subject to tax under Subchapter 2E, would not be subject to the normal tax and surtax.

[12]See p. 16, infra, et seq.

[13]Appendix, p. i.

"Net income" thus referred to is defined in section 21(a)[14] as:

> "21 (a) DEFINITION.—'Net income' means the gross income computed under section 22, less the deductions allowed by section 23."

Section 22 is the familiar section defining "gross income" to include all gains, profits, etc., and section 23 lists the various familiar deductions—ordinary and necessary expenses in carrying on a trade or business, etc.

With respect to the method of accounting to be employed, section 41[15] specifically provides:

> "The *net income* shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* * * *."

When petitioner made the special election to compute its long-term contract income on the percentage of completion basis under section 736(b) of the Excess Profits Tax Act in arriving at its "adjusted excess profits net income" under the provisions of that act, it made no change in its regular accounting methods; and it computed, as it was required to do,[16] its corporation surtax net income under the above-quoted provisions of Chapter 1 of the Internal Revenue Code in accordance with the method of accounting it regularly employed in keeping its books of account, which, as to long-term contracts, was

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[14]Appendix, p. ii.
[15]Appendix, p. ii.
[16]Regs. 111, secs. 29.41-1, 29.42-4, Appendix, pp. ix, x.

the completed contract method. Its surtax net income for the year 1942, so computed, was $821,086.11 (R. 59).[17] This was the surtax net income used for the purpose of determining petitioner's surtax for the year 1942 (R. 60); it was also the income used for the purpose of determining its normal tax (R. 60); it was its ordinary commercial income for all general corporate purposes.[18]

Under the plain provisions of Section 710(a)(1)(B), imposing the alternative excess profits tax in

> "an amount which when added to the tax imposed for the taxable year under Chapter 1 * * * equals 80 per centum of the corporation surtax net income, computed under section 15 * * * without regard to the credit provided in section 26(e) * * *,"

petitioner contended that its excess profits tax could not exceed an amount which when added to its taxes under Chapter 1 (the normal tax and surtax) equalled 80 per cent of its surtax net income computed under section 15, without regard to the section 26(e) credit; and that since 90 per cent of its adjusted excess profits net income exceeded that ceiling, its total income and excess profits taxes should be 80 per cent of $821,086.11 or $656,868.89.

It was and is undisputed that the normal tax and surtax to be used in the computation of the 80 per cent limitation should be the actual normal tax and surtax determined under Chapter 1, but the Commissioner contended that the other factor to be used in computing the amount of tax under the 80 per cent limitation was not petitioner's

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[17] Without regard to the section 26(c) credit (see note 11, supra).
[18] Regs. 111, sec. 29.21-1, Appendix, p. vii.

true "corporation surtax net income, computed under section 15" upon which its surtax in fact was based, but a specially constructed "corporation surtax net income" computed as to long-term contracts under the special percentage of completion method of accounting that petitioner had elected to use in arriving at its *adjusted excess profits net income* under Subchapter 2E. This contention was based upon a regulation issued by the Commissioner under section 736(b), which provided in part:[19]

> "The excess profits tax may be computed under section 710(a)(1)(B) as an amount which when added to the normal tax and surtax computed under Chapter 1 equals 80 percent of the corporation surtax net income computed without regard to the credit under section 26(e) (relating to income subject to excess profits tax). *For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting* * * * and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1."

In other words, the Commissioner ruled that where a taxpayer invokes the special relief provisions of section 736(b) and computes its "adjusted excess profits net income" by using the percentage of completion method for long-term contract income in arriving at the measure of the tax provided under section 710(a)(1)(A):

> "90 per centum of the adjusted excess profits net income,"

it must also compute a special corporation surtax net income under the percentage of completion method of ac-

[19]Regs. 112, sec. 35.736(b)-3(a), Appendix, p. xvi.

counting provided in section 736(b), rather than under its regular and accepted methods of accounting required by section 15, for the purpose of arriving at the alternative measure of tax under section 710(a)(1)(B):

> "80 per centum of the corporation surtax net income, computed under section 15."

The result in this case is to substitute, as the measure of the 80 per cent limitation, a specially constructed corporation surtax net income of $2,120,523.10 (R. 58) for petitioner's actual corporation surtax net income of $821,086.11 (R. 60, 174) computed under section 15 and used for the purpose of determining its surtax, and to impose upon petitioner total taxes of $1,696,418.48 (R. 184), *or more than two times the amount of its ordinary corporate income for the tax year in question.*

The sole question on this appeal is whether this ruling of the Commissioner (incorporated in the italicized sentence in the foregoing regulation) is a correct interpretation of section 710(a)(1)(B). Petitioner contends, as is so clearly pointed out in both the dissenting opinions below (R. 171, 176), that the regulation is directly contrary to the statute, defeats the cardinal purpose of Congress in enacting the 80 per cent limitation, and operates to deny petitioner the benefit of the provisions Congress enacted for the specific purpose of protecting taxpayers from inordinate burdens under the Excess Profits Tax Act.

While the Tax Court sustained the Commissioner's determination, it was by a closely divided court. Judge Van Fossan, who heard the case, wrote a dissenting opinion (R. 170), as did also Judge Kern (R. 176). Judges

Arundell, Black and Johnson concurred in Judge Van Fossan's opinion and Judges Arundell and Black concurred in that of Judge Kern.

We believe and submit, as pointed out hereafter, that the majority opinion cannot bear analysis and on its very face demonstrates the unsoundness of the Government's contention. As pointed out in the dissenting opinion of Judge Van Fossan (R. 173):

> "Although the statute nowhere suggests, and to my mind clearly dictates the contrary, the majority concludes that 'the only reasonable interpretation of the statute * * * requires the use of the basis elected for every purpose of Subchapter E of Chapter 2 * * *.' They thus write out [of] the statute the provision 'corporation surtax net income, computed under section 15' saying that this 'language does not clearly or even inferentially, prohibit computing corporation surtax net income by beginning with income upon a percentage of completion basis as required by the regulation * * *.' I cannot agree with such a negative approach to the question. The last quoted statement of the majority assumes the conclusion it seeks and clearly violates the statute."

And (R. 171-172):

> "It is my judgment that petitioner is amply fortified in his contention that the term 'corporation surtax net income' denotes a specific concept which for any year can be only the precise amount arrived at under section 15 of Chapter 1, I.R.C., and that section 710(a)(1)(B) in no way suggests a new concept of corporation surtax net income. On the contrary, Congress, by the use of the term 'the corporation surtax net income' amplified by the phrase 'com-

puted under section 15' and the reference to 'Chapter 1' indicated clearly that the 80 per cent limitation was to be based on the actual corporation surtax net income on which the corporation's surtax liability is imposed. In my judgment, section 710(a)(1)(B) was calculated to provide an alternative measure of the excess profits tax independent of the measure of such tax under section 710(a)(1)(A)."

And, again, by Judge Kern in his dissenting opinion (R. 179):

"In my opinion section 710(a)(1)(B) in using the words and figures '* * * 80 per centum of the corporation surtax net income, computed under section 15 * * *' means exactly what it says and should not be construed to read '* * * 80 per centum of the corporation surtax net income, computed under section 15 and/or section 736(b) of subchapter E of Chapter 2 * * *.'"

The foregoing statement sets out the basic facts and points of controversy between the parties. For a complete understanding of the problem, however, it is necessary briefly to review the general structure of the statutes imposing the income and the excess profits taxes.[20] Since the only dispute between the parties is one of law as to the meaning of these statutes, it would appear more appropriate to consider their provisions in the course of the argument and we turn to that portion of our brief.

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[20]This court, of course, already has had occasion to consider certain provisions of the Excess Profits Tax Act in *Stimson Mill Co. v. Commissioner of Internal Revenue*, 163 F.2d 269, and *James F. Waters, Inc. v. Commissioner of Internal Rev.*, 160 F.2d 596.

SPECIFICATION OF ERRORS RELIED UPON.

Petitioner relies upon the following errors:

The Tax Court erred:

1. In failing to hold that the phrase "corporation surtax net income, computed under section 15" in section 710(a)(1)(B) of the Internal Revenue Code refers to the specific corporation surtax net income computed under section 15 of Chapter 1 on which the surtax provided in Chapter 1 is imposed.

2. In failing to hold that the so-called 80 per cent limitation prescribed in section 710(a)(1)(B) on the amount of excess profits tax must be determined by using the regular method of accounting applicable in determining the taxpayer's surtax net income under Chapter 1.

3. In holding that the percentage of completion method of accounting elected by the taxpayer with respect to its long-term contracts applied in the determination of the taxpayer's corporation surtax net income computed under Chapter 1 for purposes of section 710(a)(1)(B).

4. In failing to hold that section 710(a)(1)(A) and section 710(a)(1)(B) provide alternative and mutually exclusive methods of computing the taxpayer's excess profits tax liability.

5. In ordering and deciding that there is due from the taxpayer for the year 1942 a deficiency in excess profits tax in the amount of $355,342.21.

6. In failing to determine and decide that there is due to taxpayer an overpayment of excess profits tax for the year 1942 in the amount of $935,575.38.

ARGUMENT.

I. THE 80 PER CENT LIMITATION IS BASED ON THE LONG ESTABLISHED CONCEPT OF CORPORATE NET INCOME COMPUTED BY USING THE TAXPAYER'S REGULAR METHODS OF ACCOUNTING AND NOT ON A SPECIAL CONCEPT OF INCOME USED IN ARRIVING AT THE "ADJUSTED EXCESS PROFITS NET INCOME" UNDER THE EXCESS PROFITS TAX ACT.

The excess profits tax was first enacted by the Excess Profits Tax Act of 1940.[21] Major amendments were added after Pearl Harbor by the Revenue Act of 1942.[22] While this statute is the most complicated taxing statute ever enacted in the history of this country, nevertheless, in broad outline, it follows a relatively simple pattern—a pattern which is quite distinct from that of the companion and coexistent income tax law and yet correlated with that statute in certain essential respects. A correct understanding of the Excess Profits Tax Act requires, at the outset, a consideration of the basic structure of the income tax law and the manner in which these two statutes function side by side.

Ever since the enactment of the Corporation Excise Tax Act of 1909[23] there has been continuously in effect an income tax on corporations. While the statutes from time to time have differed with respect to the inclusion of certain types of income (e.g., dividends received), and the

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[21]Act of June 25, 1940, sec. 201, c. 419, 54 Stat. 516. The so-called "declared value excess profits tax," imposed by section 600 of the Internal Revenue Code and in effect for many years, simply complements the capital stock tax (section 1200, Internal Revenue Code).

[22]Act of October 21, 1942, c. 619, 56 Stat. 798.

[23]Act of August 5, 1909, c. 6, 36 Stat. 11. Although this tax was called an excise tax, in deference to the decision in *Pollock v. Farmers' Loan & Trust Co.* (1895) 157 U.S. 429, and was sustained as such (*Flint v. Stone Tracy Co.* (1911) 220 U.S. 107), it imposed an excise tax measured on net income and was in practical effect an income tax.

allowance of certain deductions and credits, every one has contained provisions identical in substantial respects with the provisions of sections 21, 22, and 23 of the Internal Revenue Code (quoted supra, p. 9); that is to say, they have provided that the net income subject to tax shall be the gross income of the corporation less the deductions allowed by the statute.

Neither the Revenue Act of 1909 nor that of 1913 contained a specific provision with respect to the method of accounting to be used in arriving at net income, although the statutes were phrased in language that indicated that returns should be made on the cash receipts and disbursements basis (see *United States v. Anderson* (1926) 269 U.S. 422, 438, et seq.). Experience demonstrated, however, that income derived from certain types of businesses could not be computed on that basis alone, and the Treasury Department promulgated regulations permitting the use of other accepted methods of accounting that clearly reflected the taxpayer's income.[24]

When Congress came to enact the Revenue Act of 1916 it recognized the deficiency in the preceding statutes[25] and added section 13(d)[26] which provided:

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[24]Treasury Regulations No. 31, Dec. 3, 1909, Arts. 5, 6;
Treasury Regulations No. 33, Jan. 5, 1914, Arts. 158, 161, 182.
See: *Aluminum Castings Co. v. Routzahn*, 282 U.S. 92, 97.

[25]Report of the Committee on Ways and Means, House Report No. 922, 64th Cong., 1st Sess., p. 4:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income.

[26]Revenue Act of 1916, c. 463, sec. 13(d), 39 Stat. 756, 771.

> "A corporation * * * keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned; * * *."

In the Revenue Act of 1918[27] all of these concepts, together with provisions governing the accounting methods to be used in arriving at net income, were enacted into the income tax law.

Section 232 of that statute (40 Stat. 1077) provided:

> "That in the case of a corporation subject to the tax imposed by section 230 [the income tax] the term 'net income' means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226."

Section 226, last referred to, provided for the special case of a taxpayer changing its method of accounting during its taxable year. Section 212(b), the section of general application, provided (40 Stat. 1064, 1065):

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed,

[27] C. 18, 40 Stat. 1057.

> or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

Under this statute the Commissioner promulgated Article 21 of Regulations 45 providing:[28]

> "Meaning of Net Income—The tax imposed by the statute is upon income. * * * Though taxable net income is wholly a statutory conception it follows, subject to certain modifications as to exemptions and as to some of the deductions, lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income.' This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer."

The reservation in the last sentence of the foregoing regulation, that "ordinarily" net income is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, is merely co-extensive with the statute; that is to say, in arriving at net income under the income tax law the method of accounting regularly employed is to be used unless (1) no such method of accounting has been so em-

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[28]This article applied to individuals, but was made applicable also to corporations by Article 531 of Regulations 45.

ployed, or (2) the method of accounting does not clearly reflect the income. If these tests are met net income under the income tax statute *must* be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer.

The foregoing provisions of the Revenue Act of 1918 and the Regulations of the Commissioner thereunder have continued without substantial change to the present time. (See sections 21, 22, 23 and 41 of the Internal Revenue Code, quoted at p. 9, supra).

By the Act of February 10, 1939 (53 Stat., Part 1), all of the internal revenue laws were enacted into the Internal Revenue Code. The ordinary income taxes (normal taxes and surtaxes on individuals and corporations) were enacted into Chapter 1, and all of the familiar concepts governing the computation of income for the purposes of the income taxes became a part of that chapter.

The Revenue Act of 1941 (55 Stat. 687), by amendments to Chapter 1 of the Internal Revenue Code, first provided for a division of the ordinary income tax on corporations into a normal tax and surtax,[29] in accordance with the familiar pattern of individual taxes, and the normal tax net income and surtax net income were based upon the net income of the corporation computed under the provisions above referred to.

Thus the income tax acts (now incorporated in Chapter 1 of the Internal Revenue Code), and the regulations

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[29]Prior to that time a surtax had been imposed in special instances on undistributed profits, but no general surtax had been imposed on the ordinary net income as such.

thereunder, have from the very beginning recognized that the income computed under that chapter and subject to the normal tax and surtax is the ordinary commercial income of the taxpayer under its accepted and regular methods of accounting. "With few exceptions, if any, it is income as the word is known in the common speech of men."[30] Quite apart from technical tax considerations the reason is apparent. This "income" of the taxpayer (computed by its regular methods of accounting) is its income for all general corporate purposes. It is the income on the basis of which dividends are declared. It is the income reported in its statements to stockholders. It is the income reported to financial institutions on the basis of which credit is extended. It is the income from which its taxes must be paid. As Judge Van Fossan points out in his dissenting opinion (R. 173), it represents the taxpayer's "true earnings."

When Congress, just before the outbreak of the last war, by the Second Revenue Act of 1940,[31] elected to tax excess war profits it did not, as it might have done, simply increase the rates of taxation upon ordinary income, but instead enacted an entirely separate subchapter (Subchapter E) in Chapter 2 of the Internal Revenue Code. This subchapter levied a tax measured *not* by the "net income" of the corporation, but by the "adjusted excess profits net income," a special statutory income entirely different from the actual income of the corporation. This special "adjusted excess profits net income" defined by

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[30]Cardozo, J., *U.S. v. Safety Car Heating Co.* (1936) 297 U.S. 88, 99.

[31]C. 757, sec. 201, 54 Stat. 974, 975.

section 710(b) of the Internal Revenue Code,[32] was computed under the complicated provisions of the Excess Profits Tax Act, with its numerous adjustments, credits, exceptions and relief provisions. After this "adjusted excess profits net income" was so computed it was subjected to a graduated tax ranging, first, from 25 per cent to 50 per cent,[33] and, later, from 35 per cent to 60 per cent.[34]

After Pearl Harbor Congress sharply increased the rate of the excess profits tax by changing the graduated rates to a flat rate of 90 per cent (later in 1943 raised to 95 per cent).[35] Concerned, however, with the over-all effec-

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[32]"Definition of Adjusted Excess Profits Net Income.—As used in this section, the term 'adjusted excess profits net income' in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) Specific exemption.—A specific exemption of $5,000;

(2) Excess profits credit.—The amount of the excess profits credit allowed under section 712; and

(3) Unused excess profits credit.—In the case of a taxpayer the normal-tax net income of which for the taxable year is not more than $25,000, the amount by which the excess profits credit for the preceding taxable year (if beginning after December 31, 1939) exceeds the excess profits net income for such preceding taxable year."

[33]Section 710(a), Excess Profits Tax Act of 1940, as enacted by the Second Revenue Act, 1940, c. 757, sec. 201, 54 Stat. 974, 975.

[34]Section 710(a), Internal Revenue Code, as amended by the Revenue Act of 1941, c. 412, sec. 201, 55 Stat. 687, 699.

Under the 1940 Act the taxpayer was allowed to deduct its income taxes from its excess profits net income (sec. 711(b)(1)(A), Internal Revenue Code, as enacted by the Revenue Act of 1940, c. 757, sec. 201, 54 Stat. 974, 976). Under the 1941 Act the excess profits tax was deducted in computing the income tax (sec. 23(c), Internal Revenue Code, as amended by the Revenue Act of 1941, c. 412, sec. 202, 55 Stat. 687, 700). Under the 1942 Act the section 26(c) credit became applicable (see footnote 11, page 8, supra).

[35]Revenue Act of 1942, c. 619, sec. 202, 56 Stat. 798, 899.
Revenue Act of 1943, c. 63, sec. 202, 58 Stat. 21, 53.

tive rate of the normal tax, surtax and excess profits tax, Congress introduced a number of relief provisions to mitigate the application of the tax on the adjusted excess profits net income at the 90 per cent rate, and also, for the first time, inserted the 80 per cent limitation in section 710(a)(1)(B). It is this section about which the controversy in this case revolves.

As pointed out above, prior to these amendments the excess profits tax was based entirely on its own special concept of taxable income—"adjusted excess profits net income"—the computation of which was prescribed by the various provisions of Subchapter 2E of the Code. As to all provisions of the statute *except* section 710(a)(1)(B), the 1942 Act did not alter the measure of the tax. It remained basically a tax measured by the "adjusted excess profits net income." The many relief provisions in general merely modified the computation of this net income by affecting either excess profits net income or the excess profits credit, or both. One of these provisions was section 736(b), which gave to taxpayers meeting certain qualifications the right, "for the purposes of this subchapter" (Subchapter 2E), to compute their income from long-term contracts on the percentage of completion method of accounting.

However, at the same time section 710(a)(1)(B) added an entirely new and alternative measure of the excess profits tax. Section 710(a)(1)(A) retained the former measure, that is, the tax was

> "90 per centum of the *adjusted excess profits net income,*"

but the alternative tax, applicable if in a lesser amount, was based upon a new measure, *the corporation surtax net income computed under section 15:*

> "an amount which when added to the tax imposed for the taxable year under Chapter 1 * * * equals 80 per centum of *the corporation surtax net income, computed under Section 15* * * * but without regard to the credit provided in Section 26(e) * * *."

The foregoing review of the salient provisions and pattern of the income tax law (Chapter 1 of the Internal Revenue Code) and the Excess Profits Tax Act (Subchapter E of Chapter 2 of the Internal Revenue Code) brings into focus the issue in this case. The point of controversy is whether the corporation surtax net income, used as a measure of the 80 per cent limitation in section 710(a)(1)(B), is the actual corporation surtax net income of the corporation computed under section 15 in accordance with the taxpayer's customary methods of accounting and under the concepts of income that for nearly half a century have been incorporated in Chapter 1 and its predecessor provisions—the actual corporation surtax net income used for the purpose of computing petitioner's surtax under section 15 and reflecting its ordinary corporate profits; or whether the "corporation surtax net income" which limits the over-all tax under section 710(a)(1)(B) must be computed under the special percentage of completion method of accounting that section 736(b)—a relief provision of Subchapter E of Chapter 2—permitted the taxpayer to use in computing its "ad-

justed excess profits net income'' as the measure of the tax imposed by section 710(a)(1)(A).

We submit that the language of section 710(a)(1)(B), and the history and purpose of that provision, clearly and unambiguously show that Congress intended the limitation to be measured by the actual surtax net income on which the surtax is based—the taxpayer's ordinary corporate profits.

II. SECTION 710(a)(1)(B) IN CLEAR AND UNAMBIGUOUS LANGUAGE PRESCRIBES THE USE OF THE ACTUAL CORPORATION SURTAX NET INCOME UPON WHICH THE CORPORATION SURTAX IS BASED UNDER CHAPTER 1 AND NOT A RECONSTRUCTED OR HYPOTHETICAL SURTAX NET INCOME.

On the face of the statute, there can be no question as to the Congressional intent. Section 710(a) is explicit. To repeat, it provides that:

> ''There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, * * * a tax equal to whichever of the following amounts is the lesser:
>
> (A) 90 per centum of the adjusted excess-profits net income, or
>
> (B) an amount which when added to the tax imposed for the taxable year under Chapter 1 * * * *equals 80 per centum of the corporation surtax net income, computed under section 15* * * * but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter).''

By this section, as the foregoing history of the revenue act so clearly shows, an "entirely different and mutually exclusive statutory concept" was introduced into the statute as a measure of the excess profits tax.[36] Prior to the enactment of section 710(a)(1)(B), the excess profits tax had been measured solely by the "adjusted excess profits net income." By section 710(a)(1)(B), however, a new and alternative measure of the tax was introduced. This alternative measure was based on the familiar concepts derived from Chapter 1—the normal tax, the surtax, and the corporation surtax net income computed under section 15. When Congress used the language "corporation surtax net income, computed under section 15," it used it in the light of nearly half a century of history under the income tax acts during which concepts so well settled as to be beyond any possible misunderstanding or controversy had become imbedded in the law. In the light of that history and under those concepts "corporation sur-

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[36]The quoted clause is from the decision of this court in *Stimson Mill Co. v. Commissioner of Internal Revenue* (9th Cir. 1947) 163 F.2d 269. That case is identical in principle with the case at bar. In the *Stimson Mill* case, the taxpayer claimed the right to an excess profits credit based both on section 722, the general relief provision, and on the so-called 75 per cent rule prescribed by section 713(e)(1). This court held (p. 274) that the two separate statutory concepts of (1) "average base period net income" set out in section 713(e)(1), and (2) "constructive average base period net income" found in section 722, were mutually exclusive, one applying in lieu of the other, and that the 75 per cent rule prescribed for determining the one average base period net income could not be grafted upon the other constructive base period net income. So, too, in this case, there are involved two separate statutory concepts prescribing the measure of the excess profits tax—whichever produces the lesser tax: (1) "adjusted excess profits net income" under section 710(a)(1)(A); and (2) "corporation surtax net income" under section 710(a)(1)(B). These just as clearly are used in lieu of each other and are mutually exclusive measures of the excess profits tax.

tax net income, computed under section 15'' means and can only mean a surtax net income based upon the taxpayer's ordinary commercial income which is used for the purpose of computing its surtax under Chapter 1. As Judge Van Fossan points out (R. 171-172):

> ''* * * Congress, by the use of the term 'the corporation surtax net income' amplified by the phrase 'computed under section 15' and the reference to 'Chapter 1' indicated clearly that the 80 per cent limitation was to be based on the *actual corporation surtax net income on which the corporation's surtax liability is imposed.* * * *
>
> The majority correctly state that section 15(a), I.R.C., defines 'Corporation surtax net income' as 'the net income' minus certain prescribed credits, including the section 26(e) credit; that section 21 defines 'net income' as 'the gross income computed under section 22 less the deductions allowed by section 23', and that section 41 provides that generally 'net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer.' *These considerations are basic in the law.* Thus 'corporation surtax net income' as defined in the statutes is gross income computed under section 22 less the deductions allowed by section 23, minus certain credits enumerated in section 15(a) and all computed in accordance with the method of accounting regularly employed by the taxpayer in keeping its books. *It seems to me perfectly clear that Chapter 1 establishes a specific concept of corporation surtax net income and that this concept obtained in the present situation.''*

Section 710(a)(1)(B) refers to ''*the* corporation surtax net income.'' No other inference can be drawn from this

language than that there is only *one* corporation surtax net income. And this, in fact, is true. The *only* provisions in the Internal Revenue Code setting forth a computation of "corporation surtax net income" are in section 15, referring, for this computation, to the settled concepts for arriving at net income under the taxpayer's regular methods of accounting. (See pp. 8-9, supra.) Section 710(a)(1)(B) in no way suggests that it is introducing a new concept of corporation surtax net income upon which neither the surtax nor any other tax under the Code is imposed, and which is constructed for the sole purpose of measuring the 80 per cent limitation.

The decision of the court below would be contrary to the plain language of section 710(a)(1)(B) if the section merely referred to "the corporation surtax net income." But the section is even more specific. It describes the surtax net income as that "computed under section 15," and thus simply borrows from Chapter 1 the corporation surtax net income already computed in arriving at the corporation's surtax liability. This conclusion as is pointed out by Judge Van Fossan (R. 171), is fortified by the reference to Chapter 1.[37] Every element for arriving at the tax under the 80 per cent limitation is based upon the Chapter 1 taxes and the Chapter 1 income—the normal tax, the surtax, and the surtax net income.

The Commissioner's regulation seeks to superimpose upon the simple and logical pattern apparent on the face of section 710(a)(1)(B) a complex reconstruction of sur-

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[37] "* * * an amount which when added to the tax imposed for the taxable year *under Chapter 1* * * * equals 80 per centum of the corporation surtax net income, computed under section 15 * * *."

tax net income which injects into the well-understood concepts of Chapter 1 the complexities of the special provisions of the Excess Profits Tax Act governing the computation of "adjusted excess profits net income."

The court below put it (R. 168):

> "We compute under section 15, but the bookkeeping method is set for us by the election which placed under the percentage of completion method the income with which we started to compute under section 15."

Of course this can only mean, as Judge Kern said (R. 179), that we compute "under section 15 and/or section 736(b) of subchapter E of Chapter 2"—a view which supposes that Congress deliberately enacted confusion by resorting to a term—"corporation surtax net income, computed under section 15"—to express an amount derived in part from section 15 and in part from Subchapter 2E. Such a construction is inadmissible under the salutary rule that

> "* * * the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."[38]

In the case at bar, the completed contract method of accounting regularly used by petitioner results in a total loss for the year 1942 from petitioner's long-term contracts of $889,898.02 (R. 57). This loss is reflected in petitioner's ordinary corporate profits available for all commercial purposes, including the payment of the tax here in con-

[38] *Lynch v. Alworth-Stephens Co.* (1925) 267 U.S. 364, 370.

troversy. It is a loss which the Commissioner concedes must enter into the computation of surtax net income under section 15 to arrive at petitioner's surtax for 1942. However, the court below held that petitioner's surtax net income for the purpose of the 80 per cent limitation reflects a *gain* from petitioner's long-term contracts for the year 1942 in the amount of $409,538.97 (R. 55-56).

It is simply not true, as the court below says, "that the mere phrase 'under section 15' does not designate the method of accounting to be used," and that petitioner's corporation surtax net income "could have been computed even under section 15 under any one of several bases of accounting" (R. 168). Section 15 defines the corporation surtax net income as "net income" minus certain credits, and section 41 provides that net income *"shall be computed* * * *" in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." As Judge Van Fossan says (R. 172), "these considerations are basic in the law." Moreover if section 710(a)(1)(B), in providing that the limitation shall be "80 per centum of the corporation surtax net income, computed under section 15," does not prescribe a method of accounting, then it leaves unspecified the method of accounting to be used in arriving at petitioner's income from sources *other* than long-term contracts (by far the largest part of its income (R. 58))—an obvious absurdity.

It is no answer to suggest, as does the court below, that the term "corporation surtax net income, computed under section 15" as used in section 710(a)(1)(B) of Subchapter 2E may mean something else than the "corporation

surtax net income'' defined in section 15 of Chapter 1. The court said (R. 166):

> ''* * * we notice immediately that section 15 says that 'For the purposes of this chapter, the term ''corporation surtax net income'' means * * *.' Pointedly, then, the concept or meaning is delimited to Chapter 1, or income tax purposes. * * * for purposes of another chapter (such as Subchapter E of Chapter 2) the expression may mean something else.''

In making this statement the court completely overlooks section 728 of Subchapter 2E, which provides:

> ''The terms used in this subchapter shall have the same meaning as when used in Chapter 1, * * *.''

But the statement is subject to an even more fundamental vice. If it were true that the definition of ''corporation surtax net income'' in section 15 is ''delimited to Chapter 1, or income tax purposes,'' then ''corporation surtax net income'' would be nowhere defined in so far as it enters into the computation of the 80 per cent limitation, and the language ''computed under section 15'' in section 710(a)(1)(B) is given no meaning whatever. The truth of the matter, of course, is that it is not section 15 but section 710(a)(1)(B), *which is in Subchapter 2E,* that dictates the use of the corporation surtax net income computed under section 15 ''for the purpose'' (to borrow the court's phrase) of arriving at the 80 per cent limitation under Subchapter 2E.

Nor is it an answer to make the assertion, as did the court below, that (R. 159)

> ''* * * the petitioner's true earnings are reflected by the percentage of completion basis of accounting.

> That was the desire of the petitioner in electing that method."

It is difficult to believe that this statement was made deliberately. As Judge Van Fossan says (R. 173):

> "The statement by the majority that 'the petitioner's true earnings are reflected by the percentage of completion basis of accounting' is plainly erroneous. Its true earnings are those reflected in its income tax return and for that purpose its method of accounting with respect to long term contracts was the completed contract method. It was not the desire of taxpayer and it made no election to change that method of accounting in so far as computing its 'true earnings' was concerned. *Its election was made only with reference to the excess profits net income.* The true earnings of any taxpayer are reflected by computation thereof under the method of accounting regularly employed by it."

No considerations under the income tax law are more basic.

The court below also conceived that the doctrine of "consistency" required petitioner, after it had elected to compute its adjusted excess profits net income on the percentage of completion basis, to use the same method "in the computation and 'limitation' so-called in section 710(a)(1)(B)" (R. 161, et seq.). In support of this view it cited the only decisions referred to in its opinion (other than two cases cited generally on the question as to the weight to be given the Commissioner's regulations). It is significant to note that these decisions (discussed below), far from supporting the conclusion of the court, are

directly contrary to its reasoning on the very points for which they are cited.

A first and conclusive answer to the court's argument is that the so-called doctrine of "consistency" cannot override the clear mandate of the statute. In the statute here involved Congress has provided in terms as specific as words can read that the 80 per cent limitation shall be measured by "the corporation surtax net income, computed under section 15." Even if the Commissioner should consider that it is "inconsistent" to adopt this measure of the tax, rather than one computed under all or part of the concepts of Subchapter 2E, it is not within his province so to provide by regulation.[39] This is exactly what was held in two of the cases cited by the court below.

Commissioner of Internal Revenue v. Hecht Co. (4th Cir. 1947) 163 F.2d 194;

Commissioner of Internal Revenue v. Mackin Corporation (1st Cir. 1947) 164 F.2d 527.

In each of these cases regulations of the Commissioner under the Excess Profits Tax Act were held invalid as contrary to the statute, notwithstanding an argument that the regulations introduced consistency in accounting treatment into the statute.

The *Hecht* case and the *Mackin* case involved section 736(a), the companion provision to section 736(b) involved in the case at bar. Section 736(a) (Appendix, p. iv) permits a taxpayer who regularly reports income from installment sales on the installment basis to elect to report such income on the accrual basis in its excess profits tax

[39]See p. 54 et seq., infra.

return. The taxpayers made this election and, in accordance with the statute, adjusted the income from installment sales in computing their excess profits net income for the preceding excess profits tax taxable years. The statute provided that

> "In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940."

Accordingly, the taxpayers did not include in excess profits net income any part of the installment payments received on account of sales made before January 1, 1940, but at the same time they deducted bad debts found to be uncollectible upon installment sales made prior to January 1, 1940. The Commissioner contended, in accordance with his regulations (Regs. 109, sec. 30.736(a)-3), that these deductions were not allowable in computing excess profits net income since the income from the same installment sales had been excluded therefrom under the statute. The courts recognized that there was a seeming "consistency" in the Commissioner's argument that if items of income received in the pre-excess-profits-tax period are excluded from the computation of excess profits net income, deductions growing out of sales in the same period must also be disallowed. (See: *Hecht* case, 163 F.2d 194, 197.) But in each case, the court held the regulation invalid, pointing out that when Congress provided that no amount shall be "included" in excess profits net income on account of pre-1940 installment sales, the word "included" must be read in the light of its settled

meaning under the revenue laws as referring to an item of income and not to an item of deduction. "The word 'included' is a word of art consistently used by Congress in tax statutes to refer to income items as distinguished from items of deduction" (*Mackin* case, 164 F.2d, 527, 531). Deductions under the revenue law, the court pointed out, ordinarily are taken in the year in which "paid or accrued" or "paid or incurred," and "We think, in view of its long experience in tax legislation, that if Congress had intended to require that deductions, contrary to this general principle of federal tax law, could not be taken when 'paid or accrued' or 'paid or incurred' it would certainly have said so explicitly and not leave so important a matter to vague inference" (*Mackin* case, 164 F.2d 527, 532).

These cases thus directly support petitioner's position. They hold that the statute must be given effect in accordance with the accepted meaning of the terms used, notwithstanding the effort of the Commissioner to "legislate a provision into the statute" (*Mackin* case, 164 F.2d 527, 532) by regulations that he considers introduce a seeming "consistency" into the law.

In commenting on these cases, the court below says that the effect of these decisions is that "the accrual basis having been elected, was controlling for excess profits tax purposes * * * In short, the accrual basis having been elected, carried through" (R. 162-163). Nothing in the decision of either court gives any indication that any such ruling was made or was in the mind of the court. The decision in each case was based expressly upon the statutory language above set forth.

But aside from the foregoing there is, in fact, no "inconsistency" involved in petitioner's contention. The doctrine of "consistency" in the tax laws requires that the same accounting treatment shall be given to items of income and deductions in arriving at a measure of a tax, and this is entirely in accord with petitioner's contention in the case at bar. All of the elements entering into the computation of petitioner's adjusted excess profits net income have been computed on a consistent basis, and this is the only rule of "consistency" applied by the courts in two other cases cited by the court below,

Kimbrell's Home Furnish. v. Commissioner of Int. Rev. (4 Cir. 1947) 159 F.2d 608;

Commissioner v. South Texas Co. (1948) 333 U.S. 496.

The *Kimbrell's Home Furnishings* case also involved section 736(a). The taxpayer had elected to compute its excess profits net income from installment sales on the accrual basis and contended that, in computing its earnings and profits to be included in its invested capital for the purpose of its excess profits credit, it was entitled to include anticipated profits on installment obligations held by it at the beginning of the tax year. This represented a proper accrual on the accrual method of accounting. The Commissioner, however, had issued regulations requiring the taxpayer to disregard the accrual method in computing its accumulated earnings and profits to be included in the invested capital. The court held the regulation invalid, saying that "Since the excess profits tax must be computed by determining the excess profits net income and deducting

therefrom the excess profits tax credit, it would seem logical that the method used in determining one should be consistent with the method used in determining the other'' (159 F.2d 608, 610). The decision applies the principle of the long line of cases under the income tax laws that the method of accounting used to determine gross income must ordinarily be the same as that used to determine deductions from such gross income.

The court below, commenting on this decision, however, said (R. 164): ''There the respondent had contended much as the petitioner does here, that the earnings should be figured, like the ordinary income, upon the installment basis.'' This is patently misleading. The only computation involved in *Kimbrell's* case was the computation of the adjusted excess profits net income. Nothing said in that case has reference to surtax net income or lends any support to the decision of the court below that the measure of the tax, under section 710(a)(1)(B), is a net income computed in part under Chapter 1 and in part under Subchapter 2E.

Commissioner v. South Texas Co. (1948) 333 U.S. 496, likewise has no bearing on the case at bar. That case involved a taxpayer regularly reporting its income on the installment basis. *It had made no election under section 736(a).* Nevertheless, in computing its accumulated earnings and profits to be included in its invested capital for the purpose of arriving at its excess profits credit, it sought to include unrealized profit on installment sales in accordance with the accrual method of accounting. Again, only the computation of adjusted excess profits net in-

come was involved. The court held that the taxpayer's position was contrary to the "long-established congressional policy that a taxpayer generally cannot compute income taxes by reporting annual income on a cash basis and deductions on an accrual basis. Such a practice has been uniformly held inadmissible because it results in a distorted picture which makes a tax return fail truly to reflect net income" (333 U.S. 501).

The court below, commenting on this decision, states that the Supreme Court stressed "that it is 'uniformly held' that the *elected basis* must be followed" (R. 164). Again, this is a plain misstatement of the holding as applied to the case at bar. The taxpayer in the *South Texas* case had made no "election" of a special method of accounting for the purpose of computing its excess profits net income under section 736(a) or any other provision of Subchapter 2E. It had merely adopted, long prior to the taxable year in question, one of several permissible methods of accounting as its regular method of accounting for income from its installment sales, and had made no change in this regular method of accounting after the enactment of the Excess Profits Tax Act. The "elected basis" referred to in the above quotation from the decision of the court below was simply the taxpayer's regular method of accounting from which it sought to depart in computing its earnings and profits to be included in its invested capital.

The last case cited by the Tax Court is *West End Furniture Co.*, 6 T. C. 557, where the taxpayer also reported income on the installment basis. That case involved sec-

tion 26(e), which, as pointed out above (supra, p. 8), provides for a credit to be allowed against normal tax and surtax net income in "an amount equal to [the taxpayer's] adjusted excess profits net income (as defined in section 710(b))." The taxpayer's regular method of accounting for income from installment sales was the installment method and this method was used in computing its income under Chapter 1. However, in computing its adjusted excess profits net income under Subchapter 2E it elected under section 736(a) to compute its income from installment sales on the accrual basis. It then contended that although section 26(e) specifically provided that the credit should be "an amount equal to its adjusted excess profits net income (as defined in section 710(b))," it was entitled to compute a section 26(e) credit under its regular method of accounting. The Tax Court held that the election under section 736(a) operated to require the taxpayer to use the accrual method of accounting in computing its adjusted excess profits net income and that this was the amount section 26(e) provided should be the credit.

The court below cites this decision for the proposition (R. 165):

> "So it is seen that the method elected for excess profits tax purposes must be applied for every excess profits tax purpose, even though it is only in computing the section 26(e) credit in an ordinary income tax case."

Such an analysis is meaningless. It is, moreover, difficult to see how the Tax Court can feel that the *West End Furniture* case compels its conclusion in the case at bar, when

in its first opinion in that case it specifically approved petitioner's contention.[40]

Nothing in petitioner's contention in the case at bar is contrary in any way to the above decisions or the familiar principles they enunciate and apply. Section 710(a)(1) does not provide for the computation of income; it simply imposes a tax and provides alternative measures of that tax. In the case of section 710(a)(1)(A) the tax is 90 per cent of the adjusted excess profits net income, computed under Subchapter 2E; in the case of section 710(a)(1)(B), the tax is an amount which when added to the Chapter 1 taxes equals 80 per cent of the corporation's surtax net income, computed under section 15. There is nothing inconsistent in providing alternative and mutually exclusive measures of a tax so long as each of the respective "net incomes" by which each of the alternative taxes is measured has been arrived at by the use of consistent accounting treatment throughout. There is no more inconsistency in such a statutory scheme than there would be if Congress had, for instance, provided that the taxpayer should compute a tax of 50 per cent of its net income under Chapter 1, and a tax of 90 per cent of its adjusted excess profits net income under Subchapter 2E, and should then pay as its only tax based on income whichever amount was the lesser.

As a matter of fact, it is the Commissioner's regulation that introduces the only inconsistency into the statute, for it seeks to inject into the computation of corporation

[40]See p. 58, infra, where the *West End Furniture* case is further discussed.

surtax net income the concepts of Subchapter 2E that are entirely foreign to Chapter 1 and are concerned solely with the computation of the adjusted excess profits net income. Further, the decision offends the true consistency that Congress intended to operate under the statute, namely, a simple over-all limitation on total taxes which any businessman could understand and act upon —a limitation based not upon "the maze of novel and complicated concepts introduced into the Internal Revenue Code in 1940 by Subchapter E of Chapter 2" (Judge Kern, R. 177), but upon the familiar concepts of Chapter 1 that reflect the taxpayer's ordinary corporate profits. As the Senate Finance Committee stated in its report accompanying the bill that introduced the 80 per cent limitation (see p. 43, infra), the intent of Congress was that "*in no case* should more than 80 per cent of *corporate profits* be taken in normal tax, surtax, and excess profits tax."

III. THE HISTORY AND PURPOSE OF SECTION 710(a)(1)(B) SHOW THAT CONGRESS INTENDED THE 80 PER CENT LIMITATION TO BE MEASURED BY THE ACTUAL SURTAX NET INCOME UPON WHICH THE SURTAX IS BASED.

So clear in meaning is the statute here involved that resort to extrinsic aids in construing it is not required.[41] But if the legislative history be examined it fortifies in every way the conclusions we have set forth.

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[41] In *Slough v. Commissioner of Internal Revenue* (6 Cir. 1945) 147 F. 2d 836, 839, the court pointed out:

"All too often the attention of the courts is sought to be diverted from the language of a statute susceptible of easy

Turning backward a moment, we have seen that when Congress came to draft the bill that became the Revenue Act of 1942, the revenue laws with respect to income taxes and excess profits taxes had assumed a definite pattern. On the one side, in Chapter 1, were the provisions governing the ordinary income taxes. On the other side, in Subchapter 2E, were the provisions governing the excess profits tax. The concepts in both chapters, and the language in which they were expressed, were familiar to Congress and to the experts who aided it in drafting the statute.

Section 710(a)(1)(B)—the 80 per cent limitation provision—did not appear in the bill as passed by the House of Representatives. The House bill had increased the rate of the excess profits tax to a straight 90 per cent and had added a number of relief provisions. It did not, however, alter the basic nature of the excess profits tax as a tax measured solely by the "adjusted excess profits net income." When the bill reached the Senate Finance Committee, that committee concluded that with the increase of the excess profits tax rate to 90 per cent, protection should be given the taxpayer against the combined impact of the normal tax, surtax and excess profits tax. Accord-

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interpretation to the confusing field of interpretative rules and regulations and legislative history. Resort to such field is, of course, sometimes necessary. But not here; for the language of the statute under consideration is plain and unambiguous. If resort to legislative history had been deemed necessary, however, we think that the interpretation placed upon the statute by the minority of the Tax Court conforms to the intention of Congress as revealed by legislative history in the context."

ingly, it wrote section 710(a)(1)(B) into the bill and explained its action as follows:[42]

"The House bill placed a flat rate of 90 per cent upon excess profits in lieu of the graduated rates of from 35 to 60 per cent in the present law. Your committee concurs in this action. However, in order to cushion the impact of this severe rate in certain unusual cases and to provide incentive for economical corporate management and funds for post-war rehabilitation in the case of all corporations subject to the excess-profits tax, your committee bill contains the following provisions:

(A) Limitation on the Maximum Effective Rate of the Corporation Normal Tax, Surtax, and Excess Profits Tax.

The Committee hearings disclosed that in the case of a number of corporations, the combined effective rate of the normal tax, surtax, and excess-profits tax would approach 90 per cent. These companies have small excess-profits credits but having expanded tremendously in war work find almost all of their income subject to the 90 per cent excess-profits tax rate. Your committee feels that in no case should more than 80 per cent of corporate profits be taken in normal tax, surtax, and excess-profits tax. Consequently, the bill limits the over-all effective rate of these taxes to 80 per cent of the surtax net income before its reduction by the credit for the income subject to excess-profits tax. The effect of this provision is to reduce the excess-profits tax in such cases to an amount which when combined with the normal tax and surtax will not exceed the 80 per cent limitation."

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[42]Senate Report No. 1631, 1942-2 Internal Revenue Bulletins, pp. 504, 530.

And again at page 636 of the same report, in commenting on the bill, the Committee added:

> "This section corresponds to section 202 of the House bill. It amends section 710(a)(1) of the Code by inserting in lieu of the rate table now set forth therein a provision imposing the tax at a flat rate of 90 per cent of the adjusted excess profits net income. Your committee, however, believes that the sum of the corporate normal tax, surtax, and excess profits tax should not exceed 80 per cent of the corporation surtax net income (computed without any credit for income subject to excess profits tax). It has therefore amended this section to provide that the excess profits tax should be the lesser of the following: 90 per cent of adjusted excess profits net income, or an amount which when added to the tax imposed by Chapter 1 (other than section 102) equals 80 per cent of the corporation surtax net income computed without the credit provided in section 26(e) for income subject to excess profits tax."

The record is thus clear as to the Congressional purpose in enacting the 80 per cent limitation. Section 710(a)(1)(B) was conceived of as an entirely new and alternative measure of the excess profits tax, independent of the measure of the tax under section 710(a)(1)(A) which theretofore had been the sole measure. While the Senate Committee concurred in the proposal of the House to increase the latter rate to a "flat rate of 90 per cent of the *adjusted excess profits net income*" proposed by the House bill, it added that, "*however,*" it "believes that the sum of the corporate normal tax, surtax, and excess profits tax should not exceed 80 per cent of the *corporation*

surtax net income (computed without any credit for income subject to excess profits tax)." The two measures of tax were thus placed in direct contrast. Each was intended to function solely in its own well-defined field—the 90 per cent tax to be measured by the "adjusted excess profits net income"; the alternative tax to be measured by 80 per cent of "the corporation surtax net income." It was never intended that these two separate measures of the excess profits tax should be merged by tying the 80 per cent limitation to a hybrid income computed in part under the concepts employed in arriving at the surtax net income and in part under those employed in arriving at the adjusted excess profits net income.

Nor can there be any question as to what Congress meant when it said that "the corporation surtax net income" was to measure the limitation. Three times this measure is referred to in the Committee report as *"the"* corporation surtax net income, or *"the"* surtax net income—the expression of a familiar and unambiguous concept requiring no explanation or description.

Finally, one other and dominant purpose is evident from the Committee's report, namely, that Congress intended the 80 per cent limitation to be measured by the ordinary corporate profits of the taxpayer. Its *only* concern in enacting the measure was to provide, as the Committee emphasized, "that *in no case* should more than 80 per cent of *corporate profits* be taken in normal tax, surtax, and excess profits tax" (supra, p. 43). The effort of the Commissioner to require in this case that petitioner use as a measure of the 80 per cent limitation

an artificial amount resulting in a total tax for 1942 of more than double the amount of its "corporate profits" for that year wholly nullifies this dominant purpose.[43]

IV. NOTHING IN SECTION 736(b) OR ITS HISTORY AND PURPOSE JUSTIFIES THE CONCLUSION THAT THE 80 PER CENT LIMITATION IS TO BE BASED ON ANY AMOUNT OTHER THAN THE ACTUAL CORPORATION SURTAX NET INCOME WHICH IS USED IN COMPUTING THE SURTAX.

The court below relied heavily upon the general clause, "for the purposes of this subchapter," appearing in section 736(b). That section provides that a taxpayer having an abnormal amount of income from long-term contracts in a taxable year

> "* * * may elect, in its return for such taxable year for the purposes of this subchapter [Subchapter 2E], * * * to compute * * * such income on the percentage of completion method * * *"[44]

The court conceived that the clause, "for the purposes of this subchapter,"

> "* * * requires the use of the basis elected for every purpose of Subchapter E of Chapter 2, therefore, requires its use in the computation and 'limitation' so-called in section 710(a)(1)(B)" (R. 161).

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[43] In enacting section 710(a)(1)(B), Congress had in mind exactly the same considerations as when, by the same law, it enacted section 456 into the Code (56 Stat. 887). That section provides an over-all limitation of 90 per cent of the "net income of the [individual] taxpayer for the taxable year" on the combined rate of the normal tax, surtax and victory tax—a provision still preserved (with a ceiling of 77 per cent) in section 12 (c) of the Internal Revenue Code.

[44] Appendix, p. vi.

At the very outset, as Judge Van Fossan points out (R. 174-175), this holding involves a manifest absurdity. The measure of the excess profits tax under section 710(a)(1)(B) involves two factors, the Chapter 1 taxes and the surtax net income. If section 736(b) requires the elected method to be used "for every purpose" in computing the tax under section 710(a)(1)(B) obviously the normal tax and surtax, as well as the surtax net income, would have to be computed on the elected basis, a result contrary to the statute and to the Commissioner's regulations.

But the ruling of the court is erroneous for much more basic reasons. To construe the *general* term, "for the purposes of this subchapter," as a requirement that the 80 per cent limitation be based upon a corporation surtax net income reconstructed under section 736(b), simply writes out of the statute the *specific* provision of section 710(a)(1)(B) declaring that the limitation shall be measured by "the corporation surtax net income, computed under section 15." Such a result offends the most fundamental rules of statutory construction. It overrides a specific provision by an unnecessary extension of a general clause, ignores the history and purpose of the statute, introduces conflict instead of harmony into its provisions, and converts a remedial statute into an instrument of oppression and a trap for the unwary.

There is perhaps no rule so firmly rooted in our law as that which requires that in construing a statute all of its provisions shall be taken into account, harmonized, and

made meaningful. In addition, the courts have emphasized that the true meaning of any single section of a statute, particularly in a setting as complex as that of the revenue laws, cannot be ascertained unless it be considered in connection with other related sections and construed in the light of the history of the tax laws of which it is an integral part.

In *Helvering v. Morgan's Inc.* (1934) 293 U.S. 121, 126, the court, speaking through Justice (later Chief Justice) Stone, said:

> "But the true meaning of a single section of the statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part."

And in *Ex parte Public Bank* (1928) 278 U.S. 101, 104, the court pointed out that:

> "No rule of statutory construction has been more definitely stated or more often repeated than the cardinal rule that 'significance and effect shall, if possible, be accorded to every word. As early as in Bacon's Abridgment, sect. 2, it was said that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." ' "

The purpose of a statute is to be deduced from a view of every material part, bearing in mind that each provision was intended to have life and meaning in accordance

with the manifest purpose of the statute as a whole.[45] Words and phrases are to be given their "normal and customary meaning,"[46] remedial legislation is to be construed liberally in favor of the taxpayer,[47] and over and over again the courts have pointed out that specific provisions prevail over general ones—"However inclusive may be the general language of a statute, it 'will not be held to apply to a matter specifically dealt with in another part of the same enactment * * *.' "[48]

In the case at bar it is not only "possible" to adopt a construction in harmony with these basic principles, but such a construction is the only one that in fact accords with the plain words of the statute itself and with its purpose. Both section 710(a)(1)(B) and section 736(b) are entirely harmonious, one with the other, and each clearly fulfills its own intended function and purpose without conflict. The election under section 736(b), "for the purposes of this subchapter," is, as Judge Van Fossan points out (R. 175), an election to compute income in

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[45] *Helvering v. Morgan's Inc.* (1934) 293 U.S. 121, 126;
Alexander v. Cosden Pipe Line Co. (1934) 290 U.S. 484, 496;
McDonald v. Thompson (1938) 305 U.S. 263, 266;
Musselman Hub-Brake Co. v. Com'r of Internal Revenue (6th Cir. 1943) 139 F.2d 65, 67;
Ginsberg & Sons v. Popkin (1932) 285 U.S. 204, 208.

[46] *Wallace v. Commissioner of Internal Revenue* (9th Cir. 1944) 144 F.2d 407, 411.

[47] *Bonwit Teller & Co. v. United States* (1931) 283 U.S. 258, 263;
McDonald v. Thompson (1938) 305 U.S. 263, 266;
Slough v. Commissioner of Internal Revenue (1945) 147 F.2d 836, 839.

[48] *MacEvoy Co. v. United States* (1944) 322 U.S. 102, 107;
Ginsberg & Sons v. Popkin (1932) 285 U.S. 204, 208;
Missouri v. Ross (1936) 299 U.S. 72, 76;
Townsend v. Little (1883) 109 U.S. 504, 512;
Robinson v. United States (8 Cir. 1944) 142 F.2d 431, 432.

arriving at the "adjusted excess profits net income." So the regulations of the Commissioner expressly provide.[49] And such is the purpose to which Subchapter 2E as a whole is addressed.

As we have seen, section 736(b) was added to the excess profits tax provisions by the Revenue Act of 1942. Under the law prior thereto, the excess profits tax was based entirely on the adjusted excess profits net income computed under the special concepts of taxable income prescribed by the provisions of Subchapter 2E of the Code. If section 710(a)(1)(B) had never been added, no question ever would have arisen as to the function of section 736(b). It would have operated in full vigor in the computation of excess profits net income or the excess profits income credit, or both.

Section 710(a)(1)(B) does not alter this in any respect. Section 736(b) continues to operate in the computation of the adjusted excess profits net income. It is only *after* this net income has been computed under section 736(b) and the other provisions of Subchapter 2E, and *after* the corporation surtax net income has been computed under section 15, that section 710(a)(1)(A) and section 710(a)(1)(B) operate in the computation of the excess profits tax. Thus both section 736(b) and section 710(a)(1)(B) operate fully in every case, each in its own field,

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[49]Regs. 112, sec. 35.736(b)-2, (Appendix, p. xiv):
"The election made pursuant to section 736(b) and this section to compute income from long-term contracts upon the percentage of completion method of accounting shall apply only with respect to average base period net income and to excess profits net income for an excess profits tax taxable year."

and in harmony with each other. Neither section 710(a)(1)(A) nor section 710(a)(1)(B) pertains to the computation of income at all. They simply *impose a tax* (whichever is the lesser) upon income already computed. Under section 710(a)(1)(A) the tax is 90 per cent of the "adjusted excess-profits net income"; under section 710(a)(1)(B) it is "an amount which when added to the tax imposed for the taxable year under Chapter 1 * * * equals 80 per centum of the corporation surtax net income, computed under section 15." As Judge Van Fossan so clearly points out in his opinion (R. 175-176):

> "It is significant that Chapter 1 provides for the computation and determination of corporation surtax net income, whereas Subchapter E of Chapter 2, which includes section 736(b), provides for the computation and determination of adjusted excess profits net income. Section 710(a)(1), although included in Subchapter E of Chapter 2, *does not pertain to the computation of income of any kind but merely provides two measures for the excess profits tax,* the one being the adjusted excess profits net income and the other the corporation surtax net income without regard to the credit relating to the income subject to the excess profits tax less the tax imposed by Chapter 1."

As in the case of the legislative history of section 710(a)(1)(B) (supra, p. 43), so also the legislative history of section 736(b) demonstrates that the construction given that section by the dissenting members of the court below is the only one that accords with the Congressional intent. Section 736(b) was added to the bill that became the Revenue Act of 1942 by the Senate

Finance Committee. The report of that committee concerning this section, copied in the margin,[50] shows that Congress by this amendment intended primarily to affect the excess profits credit, which in turn affects the adjusted excess profits net income.

That section 736(b) was intended to affect only the computation of the adjusted excess profits net income and *not* "the corporation surtax net income, computed under section 15" referred to in section 710(a)(1)(B) is made even clearer by a further significant aspect of the legis-

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[50] "Many contractors under the income-tax law have elected to report their income in the year in which the contract was completed. When the excess profits tax was enacted, it was recognized that it would be inequitable to compel the taxpayer to report all of its income for a long-term contract in one year. A provision was inserted in the law which had the effect of permitting the taxpayer for excess-profits tax purposes to exclude from its income for the taxable year that portion of the income from the long-term contract attributable to other years. However, under the existing law, if such income was attributable to years in the base period, it was held by the Treasury that such income did not increase the base-period credit used by average earnings corporations in computing their excess-profits tax.

Your committee has amended the existing law to make it clear that in such cases the net income attributable to the base-period years will increase the average earnings credit.

* * * * *

Your committee has added a new subsection (b) to section 736 to provide relief to taxpayers reporting income from long-term contracts upon the completed contract method of accounting. Such income is bunched in the year in which it is reported and unless it is spread out over the period of the contract under which the work has been performed a distorted picture of the taxpayer's true earnings for such year is presented. Since only *one excess profits credit* would be allowed *in computing adjusted excess profits net income* for such year, whereas several excess profits credits would have been utilized if the income from the contract were returned in the years during which the work was being done, an inordinate excess profits tax would be collected from such taxpayer upon such income" (Senate Report No. 1631, 1942-2 Internal Revenue Bulletins, 504, 540, 657).

lative history. Section 736(b) and section 710(a)(1)(B) were both added to the Revenue Bill of 1942 by the Senate Finance Committee. Section 736(b), however, was patterned after its companion provision relating to installment basis taxpayers—section 736(a), which section is identical with section 736(b) so far as the present question is concerned. However, section 736(a) appeared in the House bill and contained a clause identical in substance with that here involved, i.e., "for the purposes of the tax imposed by this subchapter" (Appendix, p. iv). Yet the House bill did not contain section 710(a)(1)(B), and "for the purposes of the tax imposed by this subchapter" could not possibly have referred to the measure of the 80 per cent limitation under section 710(a)(1)(B), a section later inserted in the bill by the Senate Finance Committee.

V. THE REGULATIONS UPON WHICH THE COMMISSIONER RELIES ARE MERELY INTERPRETIVE, HAVE BEEN CHALLENGED BY A CO-ORDINATE BRANCH OF THE GOVERNMENT, AND ARE INVALID BECAUSE CONTRARY TO THE STATUTE.

The Tax Court accorded virtually controlling weight to the Commissioner's regulations, saying that Congress had "twice left the matter to regulation" because of the complexity of the excess profits statute and its interlocking with the income tax law. The court said (R. 160):

> "Section 736(b) specially provides that the petitioner may elect to compute its income 'in accordance with regulations prescribed by the Commissioner' upon the percentage of completion method; also, that the election shall be made in accordance with such regula-

> tions. The reason Congress so provided and *twice left the matter to regulation* obviously lay in the complexity of the excess profits statute, its interlocking with the income tax law, and the irrevocability of the election."

But the special provisions of section 736(b) relating to regulations refer only to the administration of the act. Section 736(b) provides:

> "* * * [the taxpayer] may elect * * * to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations * * *."

Thus the regulations authorized are those relating (1) to the manner of computing income on the percentage of completion method and (2) to the manner in which the election shall be made. Concededly, petitioner has complied with such regulations.

The regulation involved in this case, however, has no administrative aspect; it states a substantive measure of the tax. Congress itself provided the measure of the tax and did not leave it to regulation. The regulation here is purely interpretive—stating the "supposed command of the statute." Such a regulation must stand or fall upon an independent construction by the court of the statute upon which it is based. As Chief Justice Stone said, speaking for the court in *Haggar v. Helvering* (1940) 308 U.S. 389, 398:

> "On the argument the Commissioner admitted that this ruling served no administrative or governmental

convenience or purpose apart from compliance with the supposed command of the statute. There is thus a complete absence of those reasons which ordinarily lead courts to give persuasive force to an administrative construction and which justify their acceptance of it in preference to their own."

It is axiomatic in our constitutional law that the Commissioner has no power "to legislate a provision into the statute which Congress for good reason had seen fit to omit."[51]

> "The Secretary of the Treasury cannot by his regulations alter or amend a revenue law. All he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted. * * * The regulation * * * is manifestly an attempt to put into the body of the statute a limitation which Congress did not think it necessary to prescribe. * * * In our opinion, the object of the Secretary could only be accomplished by an amendment of the law. That is not the office of a treasury regulation" (*Morrill v. Jones* (1882) 106 U.S. 466, 467).

And see:

> *Trust of Bingham v. Comm'r* (1945) 325 U.S. 365;
> *Koshland v. Helvering* (1936) 298 U.S. 441, 447;
> *Manhattan Co. v. Commissioner* (1936) 297 U.S. 129, 134.

In the case last cited the court said (p. 134):

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules

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[51] *Commissioner of Internal Revenue v. Mackin Corp.* (1 Cir. 1947) 164 F.2d 527, 532.
And see, *Lurie v. Commissioner of Internal Revenue* (9 Cir. 1946) 156 F.2d 436, 437.

> and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity."

The fact that the Excess Profits Tax Act is a complex statute of course gives the Commissioner no more authority than he has with respect to any of the revenue laws and the courts have not hesitated so to declare. The Commissioner's authority to prescribe regulations under 736(a) is identical with his authority under section 736(b). Yet in five cases the courts have found regulations under section 736(a) to be contrary to the statute and invalid.

Commissioner of Internal Revenue v. Hecht Co. (4 Cir. 1947) 163 F.2d 194 (Regs. 109, sec. 30.736 (a)-3);

Commissioner of Internal Revenue v. Mackin Corp. (1 Cir. 1947) 164 F.2d 527 (Regs. 109, sec. 30.736 (a)-3);

John Breuner Company, 7 T.C.M. 274 (Regs. 109, sec. 30.736(a)-3);

White Brothers Co., 7 T.C.M. 570 (Regs. 109, sec. 30.736(a)-3);

Kimbrell's Home Furnish. v. Commissioner of Int. Rev. (4 Cir. 1947) 159 F.2d 608 (Regs. 112, sec. 35.736(a)-2).

And in still other cases, regulations of the Commissioner under other provisions of the Excess Profits Tax

Act have been held invalid because contrary to the statutory provisions.

J. F. Johnson Lumber Co., 3 T.C. 1160 (Regs. 109, sec. 30.711(a)-2);

The City Auto Stamping Co., 7 T.C. 354 (Regs. 109, sec. 30.711(b)-2);

Gifford-Hill, 11 T.C. No. 97 (Regs. 112, sec. 35.735-2).

In the case at bar, moreover, a special situation obtains in the administrative history of section 710(a)(1)(B) and section 736. From the very beginning officers of a co-ordinate branch of the government have been in flat disagreement with the Commissioner in respect of the question involved in the case at bar. From the time the question first arose, the Staff of the Joint Committee of Congress on Internal Revenue Taxation[52] has construed section 710(a)(1)(B) and sections 736(a) and 736(b) in accordance with petitioner's contentions. In a series of cases involving the Commissioner's regulations under section 736(a), which are identical on the point here involved with those in controversy under section 736(b), the Staff of the Joint Committee objected to proposed refunds to taxpayers, based on the regulations, on the ground that they are in conflict with the statute (R. 69, 71, 73). The views of the Staff as to

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[52]The Joint Committee of Congress on Internal Revenue Taxation is charged by statute (sec. 5011, I.R.C.) with the duty "To investigate the operation and effects of the Federal system of internal revenue taxes" and "To investigate the administration of such taxation by the Bureau of Internal Revenue or any executive department, establishment, or agency charged with their administration." It is the Committee to which the Commissioner is required to refer all refunds or credits in excess of $75,000 (sec. 3777, I.R.C.).

these regulations and the companion regulations under section 736(b) are summarized in a statement by Mr. Colin F. Stam, Chief of Staff of the Joint Committee, who assisted in the drafting of the Revenue Act of 1942 and testified at the hearings before the committees of Congress in connection with the bill.[53] This statement is set forth in the record in this case (R. 134):

> "At the present time, the staff has taken the position in several refund cases pending before it that the 80 per cent limitations should be computed on the basis of the corporation surtax net income computed under section 15, but without regard to the credit provided in section 26(e) relating to the income subject to the excess profits tax. *Neither section 710(a)(1)(B) nor section 15 defining surtax net income provides a different method for determining the surtax net income upon which the 80 percent limitation is computed where an election, if any, is made under section 736(b) of the Internal Revenue Code relating to an election on long-term contracts.*"

In addition to the foregoing conflict in construction between co-ordinate branches of the government, the Tax Court itself, when it first considered the question, reached a conclusion in accordance with petitioner's contentions. The precise point was considered in *West End Furniture Co.*, 6 T. C. 557 (stated supra, p. 38), an opinion printed in the record in this case, where the court said (R. 118):

> "Petitioner, in its amended excess profits tax return, filed on Form 1121, at item 13, computed the

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[53]See hearings before Senate Finance Committee on H. R. 7378, Revenue Act of 1942, 77th Cong. 2nd Sess. Vol. 1, pp. 77 et seq.; hearings before the House Committee on Ways and Means on Revenue Revision of 1942, 77th Cong. 2nd Sess. Vol. 2, p. 1943.

> 80 percent limitation provided for in section 710(a)(1)(B) of the code on the basis of a surtax net income computed on the accrual basis, *instead of the installment basis upon which its surtax net income was actually computed.* * * * It should, however, be pointed out that an erroneous figure was used by petitioner in arriving at the amount which purported to be the limit of income and excess profits taxes which could be imposed by reason of section 710(a)(1)(B). Its surtax net income, computed under section 15 as section 710(a)(1)(B) provides, was computed on the installment basis, and [it] is 80 percent of *that* figure which is the limit imposed by section 710(a)(1)(B)."

After the decision containing the foregoing statement was rendered, the Commissioner of Internal Revenue filed a motion requesting the court to delete this portion of its opinion on the ground that it was unnecessary for the decision of the case (R. 121). The taxpayer having no objection, this motion was granted (R. 120). While the Tax Court in the case at bar, over the dissent of five judges, has of course reached a contrary view to that earlier stated in the *West End Furniture* case, the original opinion in that case serves to emphasize the lack of consistency in the construction of this statute.

It is, of course, well settled that where an administrative construction has not been consistent and uniform, it will be "taken into account only to the extent that it is supported by valid reasons":

> "The familiar principle is invoked that great weight is attached to the construction consistently given to a statute by the executive department charged with its administration. * * * But the qualification of that principle is as well established as the principle itself.

The Court is not bound by an administrative construction, and if that construction is not uniform and consistent, it will be taken into account only to the extent that it is supported by valid reasons'' (*Burnet v. Chicago Portrait Co.* (1931) 285 U. S. 1, 16).

To the same effect are:

United States v. Mo. Pac. R. Co. (1929) 278 U.S. 269, 280;

Haggar Co. v. Helvering (1940) 308 U.S. 389, 398;

United States v. Factors & Finance Co. (1933) 288 U.S. 89, 95-96.

CONCLUSION.

For each of the foregoing reasons we respectfully submit that the judgment of the Tax Court is erroneous and should be reversed.

Dated: San Francisco, California,
January 14, 1949.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Appendix

STATUTES AND REGULATIONS INVOLVED.

Internal Revenue Code:

"SEC. 15. SURTAX ON CORPORATIONS.

"(a) CORPORATION SURTAX NET INCOME.—For the purposes of this chapter, the term 'corporation surtax net income' means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26(e) and minus the credit for dividends received provided in section 26(b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26(h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26(b)."

(b) IMPOSITION OF TAX.—There shall be levied, collected and paid for each taxable year upon the corporation surtax net income of every corporation (except a Western Hemisphere trade corporation as defined in section 109, and except a corporation subject to a tax imposed by section 231(a), Supplement G or Supplement Q) a surtax as follows:

* * * * *

SEC. 21. NET INCOME.

(a) DEFINITION.—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 26(e):

INCOME SUBJECT TO EXCESS-PROFITS TAX.—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710(b). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736(b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 95 per centum. For the purpose of the preceding sentence the term "tax imposed by Subchapter E of Chapter 2" means the tax computed without regard to the limitation provided in section 710(a)(1)(B) (the 80 per centum limitation), without regard to the credit provided in section 729(c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727.

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the

method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22(c).

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED * * *.

(a) GENERAL RULE.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

"SEC. 710. IMPOSITION OF TAX.

(a) IMPOSITION.—

(1) GENERAL RULE.—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 [95] per centum of the adjusted excess-profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26(e) (relating to income subject to the tax imposed by this subchapter), [and without regard to 80 per centum of the credit provided in section 26(h) (relating to credit for dividends paid on certain preferred stock.).]"*

"SEC. 728. MEANINGS OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1."

"SEC. 736. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) ELECTION TO ACCRUE INCOME.—In the case of any taxpayer computing income from installment sales under the method provided by section 44(a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts re-

*Matter in brackets added by Revenue Act of 1943, effective for taxable years beginning after December 31, 1943.

ceivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44(a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44(a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when

once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44(c).

(b) Election on Long-Term Contracts.—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months, if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence of four previous taxable years, the taxable years during which the taxpayer was in existence, it may elect, in its return for such taxable year for the purposes of this subchapter, or in the case of a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942, within 6 months after the date of the enactment of such Act, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations and shall be irrevocable when once made and shall apply to all other contracts, past, present, or future, the performance of which required or requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which the election is made shall be adjusted for the purposes of this subchapter, including the com-

putation of excess profits net income in each taxable year of the base period under section 711(b), to conform to such election but for purposes of chapter 1, the tax imposed by this subchapter for any prior taxable year on account of the adjustment required by this subsection shall be considered a part of the tax imposed by this subchapter for the taxable year in which such income is, without regard to this subsection, includible in gross income. Income described in this subsection shall not be considered abnormal income under section 721."

Regulations 111:

"SEC. 29.21-1. MEANING OF NET INCOME.

* * * * *

The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. (See section 41.)"

"SEC. 29.26-4. CREDIT FOR INCOME SUBJECT TO EXCESS PROFITS TAX.

A credit is provided in section 26(e) allowable under sections 13(a)(2) and 15(a) in computing normal tax net income and surtax net income, respectively. See section

108 as to certain fiscal years. The credit is allowed only in the case of corporations subject to the excess profits tax imposed by subchapter E of chapter 2. The credit does not apply to a corporation exempt from such tax under section 725 (relating to personal service corporations) or section 727 (relating to corporations exempt from excess profits tax).

In general, the credit is the amount of the corporation's adjusted excess profits net income, as defined in section 710(b). In the case of the following corporations, however, the credit is an amount of which the tax imposed by subchapter E of chapter 2 is 90 per cent:

(a) Corporations computing such excess profits tax under section 721, relating to abnormalities in income in the taxable period.

(b) Corporations computing such excess profits tax under section 726, relating to corporations completing contracts under the Merchant Marine Act of 1936.

(c) Corporations computing such excess profits tax under section 731, relating to corporations engaged in mining strategic minerals.

(d) Corporations computing such excess profits tax under section 736(b), relating to corporations with income from long-term contracts.

For the purpose of the credit in the case of such corporations, the excess profits tax (upon which the credit is to be computed) is the tax imposed under subchapter E of chapter 2 computed without regard to the limitation of tax to 80 per cent of surtax net income, as provided in section 710(a)(1). The excess profits tax is also determined for

this purpose without regard to any credit for foreign taxes allowed in section 729(c) and (d) and without regard to the adjustments provided in section 734."

"Sec. 29.41-1. Computation of Net Income.

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

"Sec. 29.41-2. Bases of Computation and Changes in Accounting Methods.

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. * * *

The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return."

"Sec. 29.42-4. Long-Term Contracts.

Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2."

Regulations 112:

"SEC. 35.710-4 RATE OF TAX.—The excess profits tax shall be whichever of the following is the lesser:

(a) an amount equal to 90 percent of the adjusted excess profits net income, or

(b) an amount which when added to the tax imposed for the taxable year under Chapter 1 (not including the tax under section 102 on account of the improper accumulation of surplus) equals 80 per cent of the corporation surtax net income, computed under section 15 or Supplement G (relating to insurance companies), as the case may be, but without regard to the credit provided in section 26(e) relating to income subject to excess profits tax.

For the purposes of section 710(a) (1) (B) and of clause (b) of the preceding sentence, the tax imposed for the taxable year under Chapter 1 is the sum of the normal

tax and surtax for such year prior to the credit under section 131 for taxes paid to a foreign country or possession of the United States. The corporation surtax net income for such purposes shall be computed by disregarding the credit under section 26(e) (relating to income subject to excess profits tax), otherwise provided in section 15(a) or Supplement G as a reduction against net income, both in determining corporation surtax net income, and in determining the amount of net income upon which is computed the 85 per cent limitation upon the credit for dividends received. In all other respects, corporation surtax net income shall be computed as provided in section 15(a) or Supplement G as the case may be.

* * * * *"

"Sec. 35.736(a)-2 Election to Compute Excess Profits Income on Straight Accrual Basis.—If a taxpayer computing income from installment sales under the method provided by section 44(a) establishes eligibility for relief in accordance with the provisions of section 736(a) and section 35.736(a)-1, it may elect in its excess profits tax return for such year to compute income attributable to installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44(a), pursuant to which income for any taxable year is determined to be that proportion of the installment payments actually received during the year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

If the taxpayer elects under the provisions of section 736(a) and this section to compute its income from in-

stallment sales on the straight accrual basis, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years and the income from installment sales for each taxable year before the first year with respect to which the election is made, but beginning after December 31, 1939, shall be adjusted for the purposes of the excess profits tax computation to conform to such election. Since no change in the computation of income from the installment basis to the straight accrual basis can be made for any year beginning prior to January 1, 1940, as a result of such election, no recomputation can be made for any year in the base period. If the taxpayer uses the excess profits credit based on income pursuant to section 713 or section 742, the average base period net income shall be the actual average base period net income with income from installment sales computed under the method pursuant to which such income was reported for the purposes of the income tax under Chapter 1 for the taxable years in such period. If the taxpayer uses the excess profits credit based on invested capital pursuant to section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736(a) and this section, except as such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939. The election made pursuant to section 736(a) and this section to compute income on the straight accrual basis in lieu of the basis provided in section 44(a) shall apply only with respect to excess profits net income for purposes of the excess profits tax imposed by Subchapter E of Chapter

2. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income shall be computed upon the basis provided in section 44(a).

* * * * *"

"Sec. 35.736(a)-3 Computation of Income on Straight Accrual Basis.

* * * * *

For the purposes of determining the excess profits tax under section 710(a) (1) (B), as an amount which when added to the normal tax and surtax for such year equals 80 percent of the corporation surtax net income computed without regard to the credit under section 26(e) the corporation surtax net income shall include income from installment sales computed upon the straight accrual basis described in this section, the credit for dividends received used in computing corporation surtax net income shall be limited to 85 percent of the net income which shall include income from installment sales computed upon such straight accrual basis, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1.

* * * * *"

"Sec. 35.736(b)-2 Election to Report Income Upon Percentage of Completion Basis.—If the taxpayer satisfies the eligibility requirements provided in section 736(b) and section 35.736(b)-1 with respect to a taxable year beginning after December 31, 1939, it may elect in its excess profits tax return for such year, or if the election is made for a taxable year the excess profits tax return for which was filed prior to October 21, 1942 (the date of en-

actment of the Revenue Act of 1942), it may elect not later than April 21, 1943 (six months after the date of enactment of the Revenue Act of 1942), to compute its income from long-term contracts upon the percentage of completion method of accounting under the provisions of section 29.42-4(a) of Regulations 111 or section 19.42-4(a) of Regulations 103 applicable to the taxable year for which the tax is being computed. An election made by the taxpayer pursuant to the provisions of section 30.736(b) (2) of Regulations 109 shall be deemed to be made pursuant to the provisions of this section.

* * * * *

If the taxpayer elects under the provisions of section 736(b) and this section to compute its excess profits net income from long-term contracts upon the percentage of completion method of accounting, such election shall be irrevocable when once made. The election shall apply to all other long-term contracts entered into by the taxpayer, whether completed in the past, or in the taxable year, or whether such contracts are partly performed and are to be completed in the future, and to contracts which may be entered into in the future as well as to contracts which have already been entered into by the taxpayer. The income for excess profits tax purposes for each taxable year prior to the year in which the election is made to compute excess profits net income from long-term contracts upon the percentage of completion method of accounting shall be adjusted to conform to such method. The excess profits net income under section 711(b) for each taxable year in the base period, for the purposes of computing the average base period net income under section 713 or section

742, shall also be adjusted so as to conform to such election and the income from long-term contracts shall be computed upon the percentage of completion method of accounting. If the taxpayer uses the excess profits credit based upon invested capital pursuant to section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from any election made under section 736(b) or this section, except as such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939.

The election made pursuant to section 736(b) and this section to compute income from long-term contracts upon the percentage of completion method of accounting shall apply only with respect to average base period net income and to excess profits net income for an excess profits tax taxable year. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income from such contracts shall be computed upon the completed contract basis.

* * * * *"

"Sec. 35.736(b)-3 Computation of Net Income Upon Percentage of Completion Method of Accounting.—

(a) *Excess profits tax taxable year.*

* * * * *

The excess profits tax may be computed under section 710(a) (1) (B) as an amount which when added to the normal tax and surtax computed under Chapter 1 equals 80 percent of the corporation surtax net income computed

without regard to the credit under section 26(e) (relating to income subject to excess profits tax). For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting. The credit for dividends received used in computing corporation surtax net income shall be limited to 85 percent of the net income determined by computing income from long-term contracts upon the percentage of completion method of accounting, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1.

* * * * *"